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# Policy Issues

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## Doing Business Reforms in Russia – Winners and Losers

Michael Heyna

*In 2012, on the first day of his third term in office as president of the Russian Federation Vladimir Putin signed various decrees aiming at boosting Russia's investment climate with the explicit goal of "creating a new economy" (Reuters, 2012) that is characterized by a more diversified and balanced structure. Within this context he stated the objective to improve Russia's rank in the World Bank's ease of doing business (short: doing business) indicator from 120th in 2012 to 50th by 2015 and 20th by 2018. (The Telegraph, 2012) Indeed, Russia achieved to boost its performance in the last four years being ranked 51st in the 2016 ease of doing business. In a first step, this article introduces the methodology of doing business and explains why this indicator is politically charged. Subsequently, we show that Russia's improvement in doing business in the past four years was mainly driven by regulatory reforms in two sub-indicators. We discuss to what extent certain economic sectors benefitted from these reforms and come to the conclusion that they are more likely to maintain the current economic structure instead of creating a new, i.e. more balanced, one.*

### Doing business: Methodology and Politicisation

World Bank's doing business project collects data from 189 countries supplied by more than 10,700 local experts, including lawyers, business consultants, accountants, freight forwarders, government officials and other professionals routinely administering or advising on legal and regulatory requirements. A questionnaire that uses a standardized business case with assumptions about the legal form of the business, its size, its location and the nature of its operations is given to the respondents. In general, the business is assumed to be a small- to medium-sized limited liability-company which is 100% domestically owned and operates in the economy's largest business city. Since 2014, data is also collected for the second largest business city of 11 economies with a population of more than 100 million – Bangladesh, Brazil, China, India, Indonesia, Japan, Mexico, Nigeria, Pakistan, the Russian Federation and the United States.

Based on the experts' information the ease of doing business score is calculated, which is a mixed value of physical and social infrastructure quality. It represents the simple average of the following 10 sub-indicators: starting

a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Each of these indicators is again subdivided into several equally weighted components mainly covering the number of procedures, time, cost and recently also the quality of the respective regulatory process. For each component the so called distance-to-frontier (DTF) score is calculated. This measures the gap between an economy's performance and the best performance (frontier) within the entire sample and ranges from 0 to 100. The lower the DTF score the bigger the gap. Hence, a DTF score of 100 would mean that there is no country in the sample that performs better in the respective component. Accordingly it is the DTF score that makes countries comparable and determines the doing business rank.

As stated by the World Bank, the project receives more than 100 queries about the data every year from governments all around the world and an active exchange of information between the doing business team and gov-

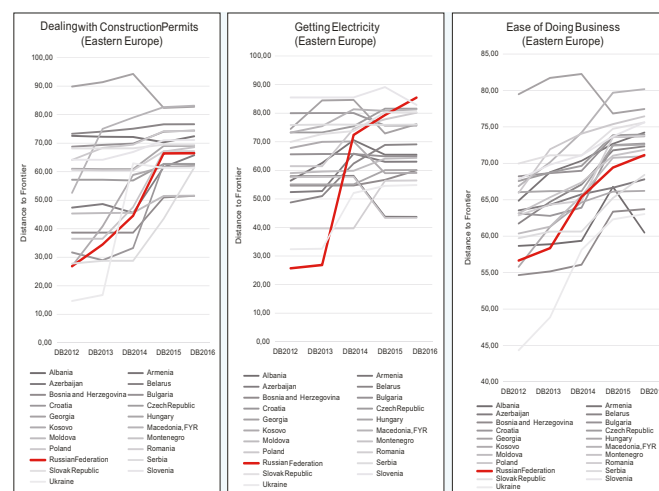
ernment officials from more than 50 countries takes place. Moreover nearly 50 governments formed committees that use doing business as a guideline for the necessity of regulatory reforms in order to improve their business environment. Among them is Russia. In addition, more than 2,000 research articles have been published in peer-reviewed academic journals using this data and the indicator is well-known throughout a considerable portion of the civil society. Furthermore it is probably the best indicator at hand that makes countries comparable regarding their regulatory business environment. Policymakers (especially from developing countries like Russia) are therefore keen to improve and internationally promote their rank in order to attract investors. Given doing business' rather simple and standardized design governments are indeed able to influence the indicators. By addressing specific components, e.g. by abolishing a number of procedures in order to shorten the respective regulatory process time or simply by revising administrative fees in order to lower costs DTF scores can be significantly raised and higher ranks can be achieved.

### Russia's rise in doing business: dealing with construction permits and getting electricity

Russia experienced a remarkable jump in the World Bank's ease of doing business rank from 120th in 2012 to 51st in 2016. As stated above, this rank is determined by the DTF score which constitutes the average value of 10 sub-indicators. Hence, the question arises which of these 10 sub-indicators have mainly been driving Russia's jump.

The aim of figure 1 is to get an idea through a graphical decomposition. It turns out that Russia's rank boost can mainly be ascribed to two sub-indicators, getting electricity and dealing with construction permits. Figure 1 shows time series plots of distance-to-frontier scores for getting electricity, dealing with construction permits and the ease of doing business for all Eastern European countries defined as such by EuroVoc. Note that Russia's development in the overall indicator is not an exception within Eastern Europe. This is not surprising because after the fall of the Soviet Union in 1990 those countries started a process of transformation with similar institutional preconditions. However, Russia's development in the two sub-indicators is quite salient. Getting electricity and dealing with construction permits show a striking similarity in their evolution. In dealing with construction permits Russia diminished its distance to frontier by nearly 39 score points from 26,85 in 2012 to 65,23 in 2016. In rank terms Russia ascended 59 positions from 178th to 119th starting as the second worst performer within Eastern Europe in 2012 and leaving eight nations behind by 2016. In getting electricity the country's rise is even more remarkable. Between 2012 and 2016 the distance to frontier has been reduced by almost 60 points (see figure 1). Russia literally bounced up 154 ranks from 183rd to 29th and placed itself from Eastern Europe's bottom to the top position.

**Figure 1: Ease of doing business, dealing with construction permits and getting electricity in Eastern Europe (2012–16)**



Source: Own graphical illustration based on Doing Business historical data

This first graphical impression is confirmed by the percentage contribution of each sub-indicator to the overall DTF-change (see table 1). Around 68 percent, i.e. more than two third of the overall DTF improvement between 2012 and 2016 is due to the DTF improvement in only those two indicators. Dealing with construction permits makes up 27 percent and getting electricity contributes 41 percent to the Russia's overall rise. The percentage contribution is derived by taking the difference in DTF-score between 2012 and 2016, multiplying it with 0.1 (each of the ten sub-indicators is equally weighted) and then dividing it by 14.33, which is the overall ease of doing business difference. For example for getting electricity the respective value is calculated by  $(84.22 - 25.71) \cdot 0.1 / 14.33 = 41\%$ .

**Table 1: Contribution of all sub-indicators to DTF-score of ease of doing business between 2012 and 2016 in Russia**

Russian Federation	Ease of Doing Business	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Minority Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
DTF 2012	56,66	82,15	26,85	25,71	81,72	62,50	46,67	75,39	45,43	75,43	44,70
DTF 2016	70,99	92,35	65,23	84,22	90,51	65,00	56,67	81,60	37,39	78,56	58,39
Difference	14,33	10,20	38,38	58,51	8,79	2,50	10,00	6,21	-8,04	3,13	13,69
Weight	1,00	0,10	0,10	0,10	0,10	0,10	0,10	0,10	0,10	0,10	0,10
Weighted Difference	14,33	1,02	3,84	5,85	0,88	0,25	1,00	0,62	-0,80	0,31	1,37
Proportion of overall difference	100%	7%	27%	41%	6%	2%	7%	4%	-6%	2%	10%

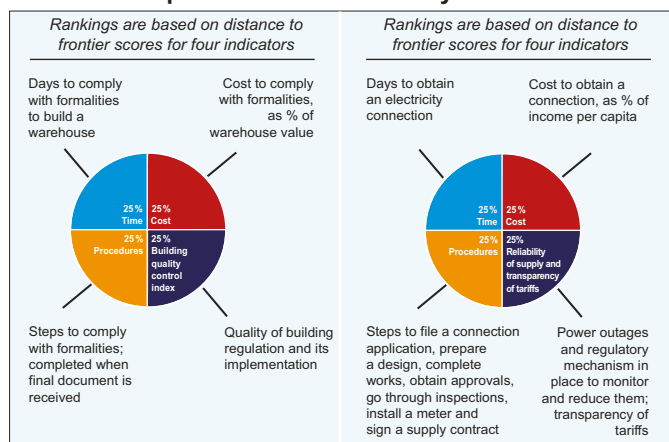
Source: Own computations based on Doing Business historical data

### Russia's rise in doing business: Reforms

To better understand the impact of reforms we should have a closer look at the methodology of getting electricity and dealing with construction permits.

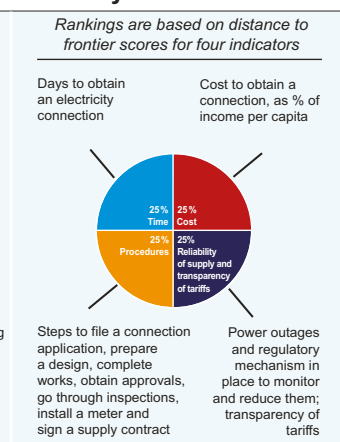
## Methodological peculiarities of getting electricity and dealing with construction permits

**Figure 2: Dealing with construction permits**



Source: Doing Business

**Figure 3: Getting electricity**



Source: Doing Business

Figures 2 and 3 illustrate the composition of the two sub-indicators that were crucial for Russia's rise in doing business. As for dealing with construction permits the business is assumed to be engaged in the construction sector. It builds a two-story warehouse of 14,000 square feet valued at 50 times income per capita and sells it after completion. The measurement of the DTF-score includes four components: first, the number of procedures to build a warehouse, from the preconstruction phase until completion, i.e. including submission of documents, receipt of licences and inspections, connection of water and sewerage utilities and registration of the warehouse. Second, the time required to complete these procedures. Third, the costs and, since 2015, a building quality control index is included as the fourth component which measures the professionalism of all approvals, inspections and supervisions (see figure 2).

Getting electricity assesses the ease of obtaining an electricity connection for a warehouse which is assumed to be owned by a local entrepreneur and consumes 26,880 kilowatt-hours (kWh). This sub-indicator is also made up by four components: First, the number of procedures to get the warehouse connected, from submitting of all relevant documents, receiving permits and inspections until obtaining external installation works and final supply. Second, time and third, cost required for these procedures. Since 2015, a reliability of supply and transparency of tariff index as the fourth component is included (see figure 3).

Given the simple design of the indicators it is quite easy to identify certain components that are important for a country's DTF score and its ranking. Based on this information, reforms can be proposed. If their implementation somehow affected a country's ease of doing business they are published and additionally described in a rather detailed way in doing business' yearly reports. Hereafter all the reforms undertaken by Russia in dealing with construction permits and getting electricity between 2012 and 2016 are presented year by year. We also inform about changes in data that are not explicitly stated in the reports itself or are due to methodological changes.

## 2012 Reforms

Russia's improvement in dealing with construction permits during 2012 is due to an abolishment of several procedures. Doing business reports that some approvals prior to construction were eliminated which makes obtaining a construction permit easier. In 2012 it took 38 steps, in 2013 only 30 steps to complete a warehouse. This leads to a time reduction of 139 days (from 452 to 313) and a cost reduction of 1.1% points (from 3.9% to 2.8% of the warehouse value).

In getting electricity no reforms were realized.

## 2013 Reforms

Russia's remarkable jump in getting electricity during 2013 was achieved thanks to reforms in several components. The regulatory process of connection was strongly simplified by halving the number of procedures from 10 to 5. Among others excavation permits for customers are now directly administered by Moscow's electricity utility (MOESK) and not via its subsidiary (MKS) anymore. Moreover, risk-based inspections conducted by The Federal Service for Ecological, Technological and Nuclear Supervision were eliminated for small- and medium-sized firms and are now only applied for larger installations. This led to a reduction of time of 119 days (from 281 to 162) which is equivalent to a cut of 42%. In addition, connection fees were standardized and lowered. In total, costs dropped by around 80%. Hence, Russia boosted its performance in all three components - number of procedures, time and cost- making obtaining an electricity connection easier, faster and cheaper. Because of this effort doing business explicitly speaks about Russia as the country with the biggest improvement in the ease of getting electricity this year.

Russia also undertook reforms to deal with construction permits more easily and faster. The number of procedures to get a building project approved were streamlined by abolishing duplicate clearances from several government agencies, i.e. the procession of permit applications was accelerated. The time for registration of a new building was shortened as well.

## 2014 Reforms

In the doing business' 2015 report no Russian reform was reported. Still, Russia improved in both indicators, dealing with construction permits and getting electricity. This is due to changes in the methodology that obviously fostered Russia's DTF score. Both indicators of interest were extended by a fourth component, a so called quality index. The ease of dealing with construction permits is now not only determined by the number of procedures, time and cost but also by the quality of building regulation and its implementation on a scale from 0 to 15. The ease of getting electricity now includes information about how reliable the electricity supply is and how transparent tariffs and prices are on a scale from 0 to 8. Russia achieved 14 and 8 points respectively and further closed the gap to the frontier in both indicators. Therefore Russia improved its position even though they did not con-



duct any reform according to doing business 2015. Nonetheless doing business' online data set reveals that number of procedures, time and cost of dealing with construction permits were reduced.

### 2015 Reforms

In Moscow and St. Petersburg the inspection of metering devices was assigned to the utility companies and accordingly made redundant additional inspections by the electricity providers. This led to a cut of one procedural step and a time reduction of more than two weeks. Furthermore connection tariffs were again drastically lowered by 66%.

In dealing with construction permits no reform is reported and no change in the data can be seen.

### Summary of Reforms

Table 2 summarizes Russia's reforms. In dealing with construction permits the number of regulatory procedures that have to be gone through starting with the preconstruction phase until completion of the building was halved, time was cut by almost 42% and cost by nearly 60%.

In getting electricity from 10 steps in 2012 only 3 are left to be taken to get a permanent connection in 2016. Whereas in 2012 it took on average 40 weeks, i.e. more than three quarters of a year to get a warehouse connected and you had to spend around 236.000 dollars, in 2016 it is less than 23 weeks and barely 13.000 dollars. This corresponds to a 43% reduction of time and a radical cut of costs (95%).

**Table 2: Summary of reforms in dealing with construction permits and getting electricity**

	Dealing with Construction Permits			Getting Electricity		
	Procedures (number)	Time (days)	Cost (% of warehouse value)	Procedures (number)	Time (days)	Cost (% of income per capita)
2012	38	452	3,90	10	281	1852,40
2016	19	263,5	160	3	160,5	93,10
Difference	-19	-188,5	-2,30	-7	-120,5	-1759,30
Change	-15%	-42%	-59%	-70%	-43%	-95%

Source: Own calculations based on Doing Business historical data

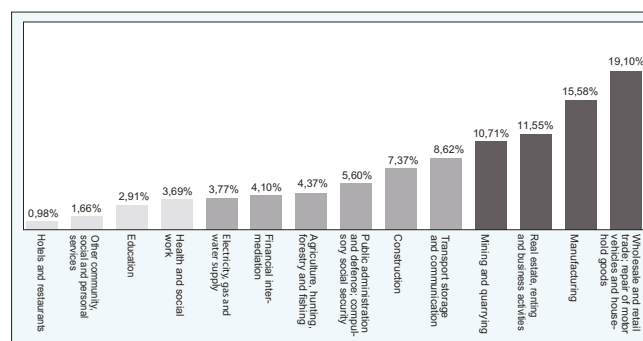
### Russia's "new" economy: Winners and losers

The aim of this section is to evaluate whether the regulatory reforms stated above favor Russia's established sectors or help to create a "new" economic structure that goes along with the government's intention. In order to do so, we first look at Russia's gross value added (GVA, a measure of output, closely linked to GDP:  $GVA + \text{taxes on products} - \text{subsidies on products} = \text{GDP}$ ) by economic activity to make apparent the importance of each sector and then compare each sector's share of GVA to its input intensity of construction and electricity.

Figure 4 presents the structure of Russia's economy. All activities that contribute to Russia's GVA are sorted by their share. The strongest sector is wholesale and retail trade; repair of motor vehicles and household

goods with close to 20% of total GVA followed by manufacturing (15,58%) and real estate, renting and business activities (11,55%). Mining and quarrying is Russia's fourth most important economic sector producing almost 11% of the country's GVA. Each of these four major sectors contribute more than 10% each and together make up more than half of Russia's GVA. Among the minor sectors we find health and social work (3,69%), education (2,91%) and other community, social and personal services (1,66%) together with hotels and restaurants being the least weighty economic activity with a share of not even 1% in total GVA. Electricity, gas and water supply and construction itself are listed as economic activities that make up 3,77% and 7,37% of the country's GVA respectively.

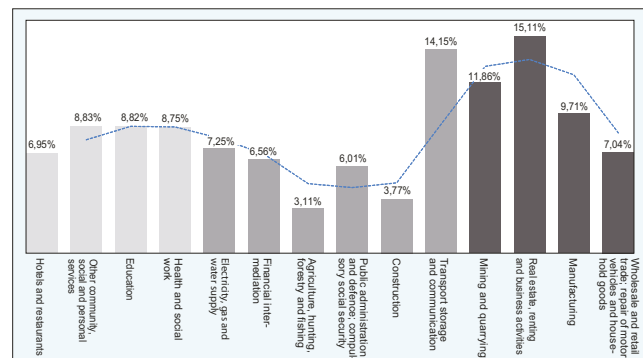
**Figure 4: Russia's Gross Value Added by economic activity (2011)**



Source: Own graphical illustration based on OECD data (2011)

Against this background, in the following we focus on the input share of electricity and construction in total intermediates for each activity to figure out which sectors most intensively use these inputs and actually benefitted from the substantial reduction of the number of procedures, time and cost in getting electricity and dealing with construction permits. Figures 5 and 6 shed light on this question.

**Figure 5: Share of electricity, gas and water supply in total intermediates by economic activity**

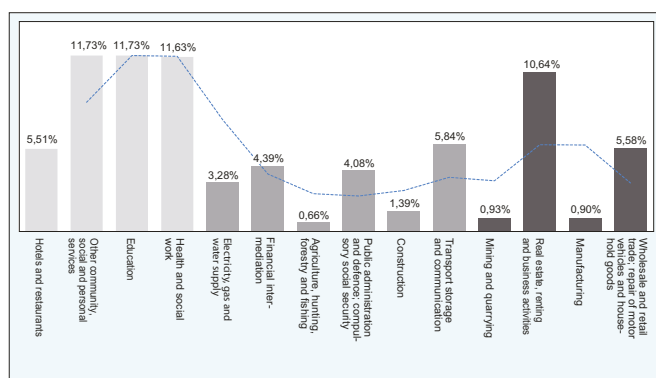


Source: Own graphical illustration based on OECD data (2011)

Regarding electricity we only have data from a composite input factor of electricity, gas and water supply. For comparability reasons we assume that the share of electricity

within this input factor is equal across activities. Further research is needed in order to get more disaggregated data and we are well aware that this may distort our findings. Looking at figure 5, we see that real estate, renting and business activities is the sector that most intensively uses electricity gas and water as an input (15% of total intermediates). Second-placed with only one percentage point less we see transport, storage and communication. Mining and quarrying is third with close to 12% and manufacturing is fourth with a share of a little less than 10%. Those four sectors also appear among the five major contributors to GVA suggesting that mainly established sectors tend to benefit from Russia's extensive reforms in getting electricity. However, it is worth to mention that the minor sectors do also show a considerable high input share of electricity, gas and water of around 8% on average. Nonetheless, we find the global maximum of the moving average trend line on the right-hand side implying that economically more important sectors are on average relative winners based on the assumption that the electricity share only is equal across sectors.

**Figure 6: Share of construction in total intermediates by economic activity**



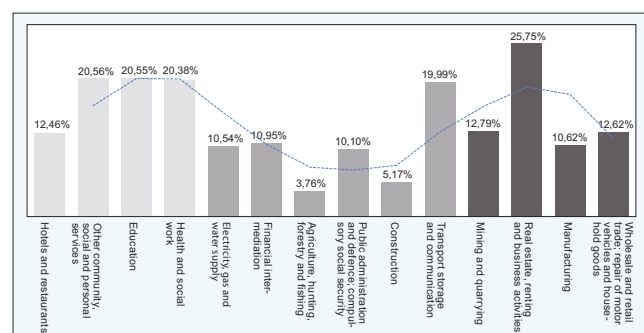
Source: Own graphical illustration based on OECD data (2011)

Turning to construction a different pattern becomes apparent. Three of the economically least important sectors have the highest share of construction in total intermediates (see figure 6). Those are health and social work, education, and other community, social and personal services with a share of almost 12% each. Among the major sectors only real estate, renting and business activities exhibits a comparable input intensity of construction (10.64%). This supports the conclusion that Russia's reforms making dealing with construction permits easier, faster and cheaper tend to foster the small sectors relative to the bigger ones. This impression is confirmed by the moving average trend line. Its global maximum is located on the left hand side suggesting that minor sectors are on average relative winners.

Thus, we get the following results. With respect to Russia's reform effort in dealing with construction permits we can clearly infer that minor sectors are winners relative to major sectors. Concerning Russia's extensive reforms in getting electricity our analysis unveils slightly different effects. The more established sectors benefit more relative to the less established ones. Now, the question

arises: What are the joint effects of Russia's reforms in the two doing business sub-indicators. When looking at the sum of shares in total intermediates of both inputs, electricity, gas and water supply and construction, we see two maxima of the moving average line of equal height. One on the left and another on the right-hand side forming a global minimum in-between (see figure 7). This suggests that in total major and minor sectors do neither lose nor win relative to each other. Their relative economic weights are prone to be unchanged.

**Figure 7: Composite share of electricity, gas and water supply and construction in total intermediates by economic activity**



Source: Own graphical illustration based on OECD data (2011)

## Conclusion

Getting back to the government's already introduced goal of creating a new economy we would have expected that Russia's reform efforts heaving the country from 120th to 51st in doing business are conducive to a more balanced structure with GVA-weights that tend to be shifted from major sectors to minor ones. However, from our findings we can conclude that Russia's remarkable rise in doing business rank, which was mainly driven by two indicators, getting electricity and dealing with construction permits, seems to have the effect of neither strengthening the current economic structure nor creating a new economy but rather maintaining the status quo. This impression is confirmed by the Russian economist Jewgenij Gontmacher: "Everybody speaks of diversification of the economy: Putin says it, Medvedev says it. In reality nothing happens." (freiheit.org, 2016) The country's boost in doing business rank is noticeable but the reforms behind this boost do not go along with the government's explicit will of creating a new, i.e. a more diversified and balanced economy. It rather helps to maintain the established economic structure.

In order to reach rank 20 in doing business by the year 2018 Russia will have to undertake further reforms. Table 1 gives an idea which indicators and components could be addressed. It reveals that trading across borders is the indicator where Russia shows by far the lowest DTF-score in 2016. Moreover it is the only indicator in which Russia experienced a decline over the past four years. So this is where Russia still has a lot to catch up. Indeed, Sylvie Bossoutrot, World Bank program leader in

Russia announced in 2015: "Trading across borders is one area where Russia should continue focusing its efforts [...] Russia did not rank well on the revised indicator which underscores the need for further improvements." The ease of trading across borders measures the time and cost to import and export. On the import side measures are based on the shipment of auto parts from the country from which it obtains the highest value of the mentioned product (in Russia's case this is Germany). According to our approach, a facilitation and reduction of costs for importing auto parts from Germany would benefit sectors that most intensively use auto parts as an input. Supposably, one of those is wholesale and retail trade; repair of motor vehicles and household goods, the sector which shows the highest share in Russia's total GVA (see figure 4). Auto parts cannot be isolated from Russia's Input-Output-Table provided by the OECD. Hence, we cannot calculate input shares in order to underpin our argumentation. Nonetheless, in the light of our main question – who are the winners and losers of doing business reforms in Russia? – major sectors would on average be relative winners meaning that the current economic structure would be strengthened if Russia undertakes substantial reforms in order to improve its performance in doing business' trading across borders in the future.

As we presented above, the overall ease of doing business score is the average value of 10 sub-indicator scores. This additive structure suggests that institutional factors are mutually substitutable meaning that a good performance in one institutional factor can compensate a bad performance in another one. For this reason Russia was able to significantly augment its ease of doing business rank from 120 to 50 through substantial reforms in mainly two sub-indicators, getting electricity and dealing with construction permits. They account for more than two third of the country's rise. Nevertheless, institutional factors are rather complementary. The compensation or masking of a bad regulatory component by a good one is unlikely to work in reality. Therefore it is questionable if Russia's remarkable jump of 70 ranks actually reflects a strong improvement of the country's overall institutional business environment. The indicator indeed signalizes that the regulatory framework is now a lot more attractive to foreign investors but it remains to be seen if foreign direct investment (FDI) in Russia will actually be positively affected. If Russia's doing business reforms have an effect at all, it is the preservation of the established economic structure.

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